



Managing Trade & Customs in China

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A Managing the China trade & customs environment

Customs rules can present complex challenges in any jurisdiction. However, if these rules are understood and managed, they can enable companies to reduce operational risks, manage costs, improve their bottom line and gain favourable recognition in the market. In China, the size of the country can create further uncertainty due to variations in practices or interpretations at different ports of entry. Although these challenges can be met, they do require a commitment of time, resources and strategic planning.

This brochure introduces some of the intricacies of import, export and customs management in China. The starting point is a clear understanding of the regulatory environment, including the structure of related government authorities. From this position, companies can move towards strategic planning options that can significantly enhance their competitiveness. These strategies can be applied either when products are imported into China, or are produced in China using imported components.

Structure of related government agencies

The General Administration of Customs (“GAC” or “China Customs”), a ministry level organisation under the State Council, has authority and responsibility over all the Customs districts and offices throughout the People’s Republic of China (“PRC” or “China”). All imports and exports from the PRC are subject to the supervision and control of the GAC. The organisational structure of the GAC can be found as an Appendix on page 24.



There are 46 customs districts or agencies and offices that report directly to the GAC. These consist of 41 customs districts, two customs educational institutions, two supervising offices in Tianjin and Shanghai, and the Guangdong sub-administration of Customs that is in charge of the seven customs districts located in Guangdong province. On the ground, the GAC administers a total 600 customs houses or offices and nearly 4,000 customs clearance control stations manned by around 50,000 personnel (including Customs anti-smuggling police).¹

Cross-border trade with China is normally performed under either General Trade or Processing Trade. General Trade is the regular import channel where customs duties and import Value Added Tax (VAT) are levied upon importation. Processing trade, on the other hand, is a special operating model whereby materials to be used in export production are imported into China under bonded status (i.e. free from customs duties and import VAT).

Customs environment for General Trade

Basic importation into China requires the payment of the proper duties and taxes. Payment of the correct amount depends on an accurate declaration of a product's value, tariff classification and country of origin.

- Types of duties and taxes

China Customs levies duties and taxes in accordance with the Customs Law of the PRC and the import/export tariff schedule. Currently, total revenue collected by China Customs comprises mainly the following:

Import Taxes	Rate
Customs duties	Varies on type of product
Value Added Tax	17%
Consumption Tax	5% to 56% depending on product
Vessel Tonnage Tax	RMB 1.5 to RMB 31.8 per ton

Following China's accession to the World Trade Organisation (WTO) in 2001, the overall average duty rate in China has been reduced from 15.6 percent in 2000 to 9.8 percent in 2010. The average tariff level is 9.8 percent in 2015. The average tariff level for agricultural products was 15.1 percent, while that of industrial goods was 8.9 percent in 2015.²

- Customs valuation

China's Customs authorities follow the valuation principles set out in the WTO Agreement on the Implementation of Article VII of the General Agreement on Tariffs and Trade (GATT) or the WTO Agreement on Customs Valuation.

The current regulation on customs valuation in China is the Measures of China Customs on Determination of Dutiable Value of Imports and Exports i.e. GAC Decree No.213, which was published on 25 December 2013. According to the measure, the dutiable value of imported goods should be assessed based on the transaction value, which is defined as the complete actual price of the goods, including both direct and indirect payments made by the buyer to the seller.

In addition to the above, Measures of China Customs on Determination of Dutiable Value of Bonded Goods for Domestic Sale i.e. GAC Decree No.211 (the "Measures"), was published on 25 December 2013. According to the Measures, the dutiable value of bonded goods for domestic sale should be assessed based on the transaction value, too.

¹ Source from GAC official website:
<http://www.customs.gov.cn/publish/portal0/tab49567/>

² GAC Guidance for the 2015 Tariff Proposal from official website of Ministry of Commerce:

For cases in which there is no transaction value (e.g. no-sale situations), or where the transaction value is deemed unacceptable (e.g. due to conditions attached to the sale of the product), China Customs employs, in hierarchical order, another five methods of appraisement. The table below summarises the WTO appraisement hierarchy:

Method	
1. Transaction value	Generally the invoice price with possible adjustments based on Article 8 of the WTO Customs Valuation Agreement
2. Transaction value of identical goods	Comparable volumes and time period
3. Transaction value of similar goods	Comparable volumes and time period
4. Computed value	Cost-plus. May be interchanged with method five
5. Deductive value	Resale-minus. May be interchanged with method four
6. Fall-back value	The fall-back method is a last resort and gives China Customs greater latitude to assign a basis for customs duties provided that this is consistent with the WTO principles

Customs valuation is a common area of difficulty between Customs authorities and importers. More details about issues regarding this area may be found later in this brochure.

In June 2015, the World Customs Organization (WCO) released the Guide to Customs Valuation and Transfer Pricing. The publication of the Guide shows the cooperation between tax and customs authorities regarding the Transfer Pricing (TP) of Multi-national Enterprises (MNEs) has been enhanced continually. The Guide sets out the methodology for both Customs Valuation and TP regimes and provides guidelines for customs to use TP information to examine Customs Valuation of related party transactions.

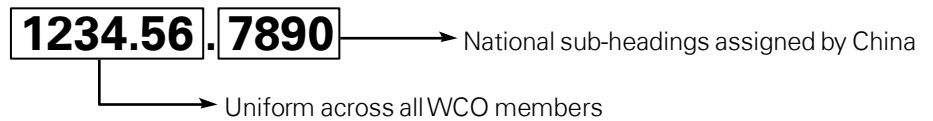
Customs Valuation and TP are similar in that both ensure that the price is set as if the parties were not related and had been negotiated under normal business conditions. Customs administration focuses on whether or not a price has been “influenced” by the relationship between the parties, while the tax administration is to seek an “arm’s length transaction price”, which ensures proper profit of different entities. For example, the WTO deductive value method is similar to the OECD resale price method, while the WTO computed value method is similar to the TP cost plus method.

Considering the above similarity, the Guide encourages customs to use TP documents when reviewing the transaction price of related parties which could save time and business cost for MNEs on the preparation of the specific documents submitted to customs. However the main challenges for customs when referring the TP documents will be single product verses company profitability product range, date range and so on.

- Tariff classification

The determination of the correct Harmonised System (HS) Code for tariff classification purposes is important since the applicable customs duty rates and import licences/certificates for specific imported goods are determined according to their HS Codes. In China, these HS Codes typically consist of eight to 10 digits.

Sample HS Code



The first six digits of these codes are similar to those used by other members of the WCO. However, the final two to four digits may differ from those used by other countries. These potential inconsistencies, if left unchecked, may lead to disputes or non-compliance issues.

To gain more certainty on the tariff classification of a product to be imported into China, the importer may apply to China Customs for a pre-determination on the appropriate HS code. Such an application should be made 45 days before the actual importation of the goods.

It is important to note that HS codes are also relevant to export VAT refunds and license since a product's tariff classification determines the refund rates of exports, and hence the amount of refundable input VAT, which in our experience, can be substantial.

- Country of origin

It is important for both importers and exporters in China to properly identify their product's country of origin due to the potential impact that would have on the customs duty rate that may be imposed on their product either in China or in its country of destination.

China is involved in various preferential Free Trade Agreements (FTA) that grant lower rates of duty for products that originate in China. These FTAs in particular also provide reciprocal treatment in China for goods that are imported from other countries that are members of the specific FTA. The FTAs available to companies in China will be discussed further in the Strategic planning and savings section of this brochure.

The Chinese government deems FTAs as a new platform to further opening up to the outside and speeding up domestic reforms, an effective approach to integrate into global economy and strengthen economic cooperation with other economies, as well as particularly an important supplement to the multilateral trading system. Currently, China has 19 FTAs under construction, among which 14 Agreements have been signed and implemented already.

China-Republic of Korea (ROK) and China-Australia FTAs were signed and implemented in 2015. China and the ROK agreed to eliminate tariffs on 90 percent of all goods, and 85 percent of imports by value within 20 years after the FTA becomes effective. For the China-Australia FTA, 85.4% of merchandise in both countries will be duty free. This percentage will increase in phases, eventually reaching 100% in Australia for both tariff items and trade value, and 96.8% and 97%, in China, respectively. These tariff reduction rates greatly exceeded other ordinary FTAs tariff reduction rates at approximately 90%.

Companies are advised to closely monitor developments and policies relating to the FTAs. We recommend they review their list of goods (for import and export) as well as the relevant contracts to be more familiar with the status of their trade in goods.

In addition, it is important for companies to train their customs staff or build an internal team to study and work on how they could benefit from these FTAs.

- The rules of origin

To determine whether a product originated in China or in other FTA member countries, companies must ensure their compliance with the Rules of Origin (ROO). The ROO generally defines the country of origin as the place where the “last substantial transformation” took place. Compliance with this criterion usually requires meeting a minimum regional value content or undergoing a change in tariff classification (e.g. a change in the first four digits of the HS code) from raw/intermediate material to a finished product.

A Certificate of Origin will be issued as proof of compliance with the ROO, which must be presented to the Customs authorities in order to enjoy the preferential rate of duty. In China, Certificates of Origin for preferential purposes are issued by the Bureau of Commodity Inspection and Quarantine. Companies have to register in advance with the Bureau to apply for Certificates of Origin. For the ASEAN-China FTA, the Certificate of Origin used is also known as a Form E.

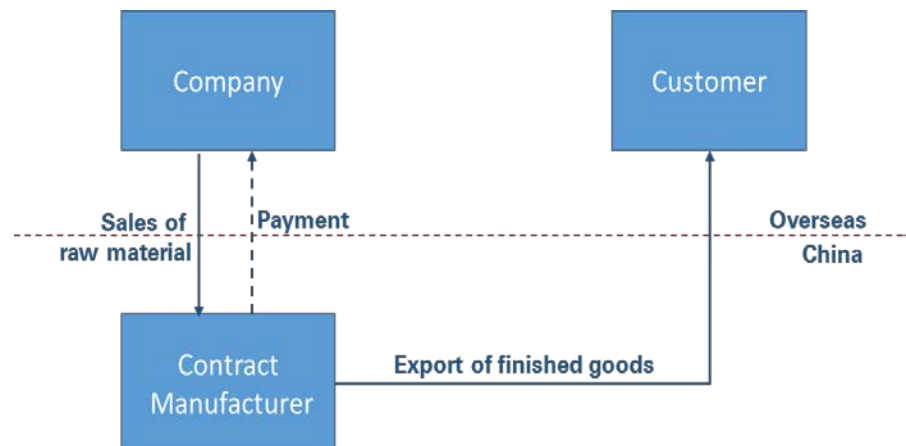
Customs environment for processing trade

Manufacturers involved in the production of goods for export may realise substantial savings upfront by importing their raw materials through a processing trade arrangement. Each processing trade application, however, requires a thorough evaluation by China Customs. In order to qualify for operations under processing trade, manufacturer are required to comply with the requirements pertaining to the raw materials to be imported, the type of processes to be undertaken, and the sophistication of their inventory management system, among others.



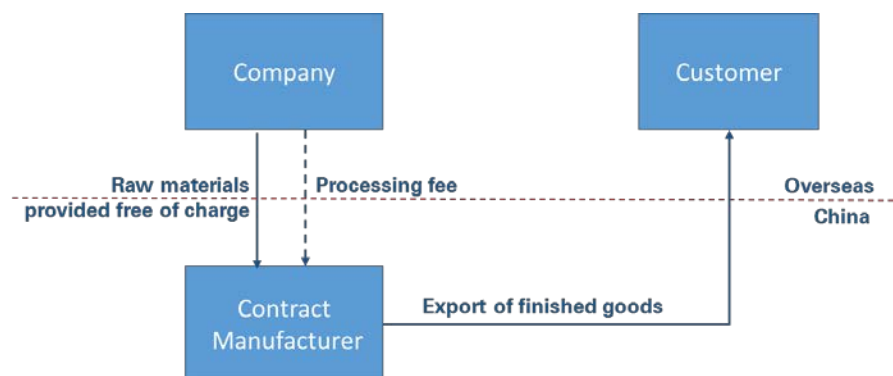
There are normally two types of processing trade models that can be adopted by a Chinese manufacturer:

1. Import Processing model



Under the Import Processing model, a Chinese manufacturer is allowed to purchase raw materials from overseas suppliers free of import duty and VAT. It then performs manufacturing functions and exports the finished goods to an overseas party. The title to the imported raw materials is transferred from the overseas supplier to the Chinese manufacturer.

2. Contract Processing model



The Contract Processing model is an alternative method to import raw materials with duties and VAT suspended. Under this model, the overseas supplier provides raw materials free of charge to the China manufacturer for processing.

The finished goods are then exported to the overseas party. In contrast to the Import Processing model, there is no transfer of title to the raw materials under Contract Processing. The manufacturer is only compensated by the overseas party with a processing fee.

If any of the bonded materials under processing trade are diverted for domestic consumption, China Customs would collect the corresponding amount of duties and VAT.

Import and export licensing

A number of products are regulated by the Chinese government and require special licenses prior to their import into or export from China. These include pharmaceuticals, encryption technologies, chemical fertilisers, and products containing “homegrown” technologies.

These permits are normally issued by the Ministry of Commerce, while the actual policies are formulated and enacted by the State Council. Importers and exporters are required to make accurate declarations and submit the requisite import or export licenses to Customs for examination. In the absence of necessary import or export licensing documents, goods subject to import or export restrictions shall not be released.

If bonded materials subject to import licensing were imported under processing trade and later sold locally, such a sale is only allowed if the proper amount of customs duties and VAT is collected and the appropriate import licenses are secured and presented to Customs.

Foreign exchange controls

China’s regulations on foreign exchange controls have progressively relaxed to accommodate the rapid expansion of its trade with the rest of the world and the rising economic significance of the Renminbi (RMB). Gradually more transactions are being settled in RMB. An RMB Trade Settlement simplifies tax and customs documentation in that (i) foreign exchange verification documents can be waived for customs declaration and export VAT refund (exemption) purposes, and (ii) the export tax refund (exemption) policy shall apply to export trades settled in RMB. Companies are encouraged to review their current documentation with a view to strengthening their compliance from a customs and tax viewpoint to ensure that these aspects are considered as part of the project implementation.

Export controls

Many Chinese companies use the Hong Kong Special Administrative Region (SAR) as their trading gateway to and from the rest of the world.

However, although Hong Kong is a free port, it enforces strict controls on the import and export of so-called “strategic commodities”, or products which have both military and civilian applications. This includes all goods from the US or products containing US technology that are subject to the US Export Administration Regulations. Examples of these products are electronic devices, integrated circuits and aerospace products. It is important for US companies to ensure that import and export licenses for these products are obtained when these are brought into or transshipped from Hong Kong to a third country. Failing to comply with these requirements could lead to heavy penalties for both the Hong Kong company and the US-based headquarters. US companies in Hong Kong should verify the applicability of any US export controls on their products and make certain that the proper licenses are obtained for these goods before these are imported into/exported from Hong Kong. Please note that Hong Kong has the most stringent export licensing requirement in the region as the southern China gateway.

Enterprise internal controls

Customs in China published Provisional Measures of the Customs of the People’s Republic of China on Administration of Enterprise Creditworthiness and Customs Standards for Certified Enterprises in 2014 to adjust the compliance management regulations on enterprises; it also laid the legal foundations for mutual recognition of Authorised Economic Operator (AEO) and C-TPAT.

China Customs replaced the previous enterprise management system (i.e., AA, A, B, C, and D ratings) with a more simplified system of classification (i.e., Advanced Certified Enterprises, Generally Certified Enterprises, Regular Credit Enterprises, Discredited Enterprises) to bring it in line with internationally accepted best practices. These changes directly affected the selection criteria, range of benefits, and enterprise ratings currently enjoyed by companies.

In addition, China Customs is introducing and establishing an enterprise self-discipline system and regulations for a Voluntary Disclosure Program.

Since this will impact all companies transacting with Customs, it is very important for management to fully understand and cautiously consider these expected changes in light of the immediate implications these could have on their existing qualification, the efficiency of their Customs clearance process, and their chances of being subject to customs audits in the future. Companies seeking to upgrade their current enterprise rating in order to avail themselves of AEO benefits are encouraged to revisit the viability of their present situation in consideration of these anticipated changes.

Quality and quarantine controls

Except for China Customs, China Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) is one of the most important authorities supervising international trade in China. Except for licenses and duty, which are taken care of by Customs, the entry-exit quarantine, the safety and quality supervision of foodstuff and equipment, skin care and cosmetic products, the science and technology of goods, the standardisation of goods, etc., are all supervised by various departments within AQSIQ, such as the China Entry-exit Inspection and Quarantine Bureau (CIQ). Importers should pay attention to the laws and regulations covering AQSIQ to get smooth and effective clearance.



B Strategic planning, savings and efficiencies

Amidst the complexities of the China Customs landscape, companies can explore a number of strategies to reduce their costs of importing and exporting in China. These include special customs supervision areas, value unbundling, tariff engineering and third party logistics management.

Special customs supervision areas

As a complement to the processing trade arrangement, China has also established various special customs supervision areas to promote itself as a world-class manufacturing hub. Following China's accession to the WTO, China Customs has expanded the scope of permissible bonded operations from manufacturing to include logistics operations.

Major customs special supervision areas and locations include bonded logistics centers (BLCs), bonded logistics parks (BLPs), bonded ports (BP), bonded warehouses (BW), export processing zones (EPZs), export supervisory warehouses (ESWs) and free trade zones (FTZs). The common denominator among these special areas is that materials may be imported into these zones free from import duties and VAT under Customs' supervision. However, each of them has unique characteristics that afford different sets of advantages and limitations to different types of businesses.



Type of customs supervision area	Limitations
Bonded logistics center (BLC)	• No processing trade activities
Bonded logistics park (BLP)	• No processing trade activities
Bonded ports (BP)	• No limitations
Bonded warehouse (BW)	• No processing trade activities
Export processing zone (EPZ)	• Generally not for logistics/warehousing activities
Export supervisory warehouse (ESW)	• No processing trade activities
Free trade zones (FTZ)	• Goods must be physically exported out of China to claim export VAT refund

Customs is also encouraging more high-value added activities to be performed inside these areas. To facilitate this, Customs has established special supervision centres and computerised networking systems, such as high-tech research and development centres, product inspection and maintenance centres, logistics centres and regional operation settlement centres to provide support to enterprises producing high value-added commodities.

The State Council published the *Notice of Release the Plan on Speeding up the Integration and Optimisation of Areas under Special Customs Supervision Areas* ("the Plan") on 28 August 2015, to guide the integration and optimisation of areas under special customs supervision and propose timetables for related work. This document may not only affect traditional bonded processing, modern logistics and traditional trading businesses but also facilitate the cross-border leasing, cross-border e-commerce, maintenance and test, and reproducing industries. Enterprises operating in related sectors in China should pay close attention to this document.

The Plan involves many areas which have long concerned related industries. Enterprises engaging in traditional bonded processing, bonded logistics, traditional business trade, cross-border leasing, cross-border e-commerce, maintenance and test should thoroughly study the Plan and pay close attention to its implementation progress. These industries could take advantage of breakthrough development opportunities in the relevant areas. Since it takes time to go from the issuance of the Plan to its implementation in local regions, enterprises can take advantage of this lag to evaluate the Plan's effect on them from such perspectives as industry entry, customs, tax, inspection and quarantine, foreign exchange, marketing, supply chain and logistics operation to ensure fully enjoying the benefits brought by the policies and maintaining compliance at the same time.

The China government introduced the pilot FTZ concept and started to set up the first pilot FTZ in Shanghai in 2013, with a view to support the development of new types of business such as finance leasing and bonded repairing in the special zones. There are currently four pilot FTZs: Shanghai, Guangdong, Fujian and Tianjin. Pilot FTZs evolved to be comprehensive areas which include not only the special customs supervision areas as it was at the very beginning but also other functional areas of finance, high-tech innovation and etc. that are treated as domestic from Customs perspective. The admittance of foreign investment into these four pilot FTZs are now managed according to the Overall Plan and Negative List released by the State Council.

Case:

Client	A global service provider of leasing/maintenance
Engagement	Customs supervision area advice
Services	<p>A global service provider of leasing/maintenance wanted to expand its business in China by setting up a service/maintenance centre in a Special Customs Supervised Area (SCSA) and engaged KPMG China to provide advisory services for preliminary SCSA planning.</p> <p>KPMG China provided the company with an analysis and recommendations relating to the location of the centre, the arrangements on the flow of goods, cash and information, and the impact of different operation models on their financial statements.</p>

Unbundling

Under the WTO Customs Valuation Agreement, the final price actually paid or payable for goods by an importer is the value that must be declared to Customs. This includes universal additions to the price such as royalties, as well as legal deductions.

However, certain cost elements included in the final price can be stripped out, thus lowering duty costs, and potentially other indirect tax costs.

Non-dutiable cost elements include after-sales or post-implementation services such as training, assembly and maintenance. Other cost elements such as finance charges, inspection fees, sales and marketing costs, and certain types of commissions can also be deducted based on a review of the supplier agreements and payment structure.

According to the latest regulations, insurance premiums, storage charges and freight and related expenses incurred in special Customs supervision areas or bonded supervision areas which can be listed separately and inclusive in the said domestic sale price shall be excluded from the dutiable value of bonded goods for domestic sale. Related operators can revisit current cost structure and contract arrangement and explore with local in-charge customs on this saving opportunity.

Free Trade Agreements

Regional and bilateral FTAs are booming. They offer preferential duty rates for trade between Asian states as well as global trade. The question is whether the benefits of these preferential duty rates outweigh the internal administrative costs of complying with the country of origin and documentation requirements.

Exploring the FTA landscape can reveal significant reductions in duties and import-related costs, and even if a company is already claiming FTA benefits, closer examination of practices and procedures may reveal that critical compliance requirements are not being met. Early identification of non-compliance can help companies make the changes necessary to help avoid costly customs penalties. Currently China has FTAs with the following regional groupings:

Regional FTA	Member countries
Asia-Pacific Trade Agreement (APTA)	China, Bangladesh, India, Laos, Republic of Korea, Sri Lanka
ASEAN-China Free Trade Area	China, Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam

It also has bilateral FTAs with the following countries/territories:

- Australia
- Korea
- Switzerland
- Chile
- Pakistan
- New Zealand
- Singapore
- Iceland
- Costa Rica
- Peru
- Hong Kong
- Macau
- Taiwan

Case:

Client	Major Korean electronics manufacturer
Engagement	FTA advice
Services	<p>Client sought KPMG China's advice on options to reduce its duty burden on its exports of anti-static boots imported into China.</p> <p>KPMG China advised that since Korea and China are members of the APTA, they can enjoy reduced duty benefits, provided that their product meets origin requirements. After confirmation of the country of origin, it was found that 40 percent of the company's products sold to China could enjoy the conventional tariff rate, which was two percent lower than the MFN rate. That year, the company was able to realise at least RMB 1 million savings in duty and VAT.</p>

Tariff engineering

Tariff classification, based on the physical form of the goods, determines the rate at which duty is payable on import. Therefore, changing the state in which goods are imported offers the potential to change the tariff classification of declared goods and reduce the associated duty cost. For example, breaking down fully assembled goods into components, sub-assemblies or individual parts could result in the goods being subject to different tariff classification numbers which confer more favourable tariff rates. There are certain restrictions on this type of tariff planning, so it is important to pay close attention to the rules pertaining to specific industries and tariff heading when considering this opportunity.

Management of third party service providers

Many companies rely heavily on third parties such as customs brokers and freight forwarders, particularly in the early stages of their market entry. As such, a lot of responsibility is entrusted to these third parties, particularly involving functions that could have administrative, risk management or strategic ramifications. It may be more cost effective to turn these responsibilities over to in-house resources, or at the very least, to assess the cost-benefit ratio of paying a third party to perform all these services.

If a company uses multiple customs brokers or agents, it may be wise to reduce the number of service providers and leverage better economies of scale on filing fees and administrative charges. It is also beneficial to install insiders in the customs management role, as they will have a broader understanding of the company's business processes. This can prove critical for strategic planning and proactive risk management in the future.



First sale for export

When a China manufacturer sells to the US or the EU through a middleman in Hong Kong, the profit earned by the middleman can be excluded from the customs value of the goods when declared to US or EU customs. It is called the “first sale for export” principle, because it refers to the imposition of customs duties on the selling price between the China manufacturer and the Hong Kong middleman or the “first sale” as opposed to the selling price of the goods on the “second sale” i.e. the Hong Kong middleman to the US importer.

In order to qualify under this scheme, four conditions should first be met and proved to US or EU Customs:

- **There is a bona fide sale between the seller and the middleman:**
The circumstances and documentation demonstrate that all parties function as “proper” buyers and sellers under the First Sale for Export Principle.
- **The transaction is at arm’s-length:**
The importer must substantiate that the manufacturer’s prices to the related middleman are at arm’s-length.
- **The goods should be clearly destined for the particular end market:**
The goods must be clearly destined for the US or EU at the time of the sale.
- **There is full documentation and recordkeeping of the transaction:**
The importer must provide to Customs, and make available upon request, all documentation that supports the above requirements and clearly establishes the role and purpose of each party in the transaction.

C Common trade and customs management issues faced by companies

The complexity of rules in China may lead to challenges in the management of a company's customs function. Based on our experience, issues most commonly arise in the areas of customs valuation, tariff classification and processing trade.

Customs valuation

Customs valuation is a hot topic for companies operating import and export businesses. In practice, there are dedicated departments focused on investigation of customs valuation cases. To ensure the payment of proper duties and taxes despite these special circumstances, Customs has increased their attention on validating the transaction value of related parties and investigating potential duty liabilities on non-trade payments such as royalties and service fees.

Valuation with related-party transactions

Many multinational companies sell goods or material-related subsidiaries in China. China Customs may scrutinise these related-party sales more carefully to verify that these sales are at arm's length (i.e. the transaction value is reasonable and not influenced by the relationship between the parties).

In addition, effective from 30 March 2016, China importers are required to make declarations on three newly added items to the customs declaration forms, which are "Confirmation of Special Relationship", "Confirmation of Price Impact" and "Confirmation of Payment of Royalties". These three items are required to be declared on each individual importation. With these declared information, Customs would be able to retrieve data efficiently which enable them to choose companies to perform valuation audit.

To meet requirements set out by both customs and tax authorities, interaction between customs valuation and transfer pricing regimes has long been the attention of companies with significant cross-border intercompany transactions.

Upon the publication of the WCO Guide to Customs Valuation and Transfer Pricing, it could be easier to persuade the China customs officials to refer to TP documents (especially TP Contemporaneous Documentation for TP compliance purposes) for customs valuation purposes. This practice could benefit the solving of the controversial valuation issues. Therefore, the compliance requirements of customs should also be carefully considered by MNEs to achieve compliance in China from both customs valuation and TP perspectives. It remains to be seen if the China customs authorities will change their position or carry out an innovative approach to handle the downward price adjustment issue, and companies should pay attention to these changes to coordinate customs valuation and TP.



Average value benchmarking

China Customs uses a database of average benchmark values as a reference in assessing related-party prices. Although these benchmarks are intended for reference purposes only, it is not uncommon for China Customs to mention these values – a practice which other customs jurisdictions regard as inconsistent with WTO principles. Notably, even if the database yields no comparable price information, China Customs still has the authority to question the acceptability of the declared value without the need to provide evidence. Thus, it is important for the importer to take responsibility for collecting the relevant evidence to prove that their relationship does not influence the transaction value.

Disputes

When Customs raises a price in query regarding a related-party transaction, the importer should submit a written explanation letter and provide evidence to prove that the invoice price or contract price approximates the price of the same or a similar product sold to a third party buyer that has been accepted by China Customs. During this period, Customs can detain imported goods whose transaction value is considered unreasonable, or request that the importer pay a guarantee deposit. If the importer cannot provide any explanation or the contents of the explanation letter submitted are deemed insufficient by Customs, Customs will determine a new import price after discussion with the importer, which will almost certainly result in higher duty and import tax liabilities.

Non-trade payments

In recent times, Customs has also become stricter about non-trade payments such as royalties and service fees.

- **Royalties**

According to the Valuation Rule, “royalties” refer to the charges paid by the buyer of imported goods for obtaining permission to use or transfer the patents, trademarks, know-how, copyright, distribution rights or selling rights of the owner or its valid agent of intellectual property. The royalties that the buyer needs to pay to the seller or the relevant party directly or indirectly should be included in the dutiable value, unless it is under either of the following circumstances:

1. the royalties are irrelevant to the imported goods (condition 1)
2. the payment of royalties does not constitute the conditions for the imported goods to be sold within China (condition 2).

If royalties are paid, the buyer takes responsibility to prove to China Customs that Condition 1 or 2 have been met, otherwise, the royalties will be dutiable. In practice, it is difficult for the buyer to prove to China Customs that Condition 2 has not been met. Thus, in order to persuade China Customs that the royalties are non-dutiable, the buyer needs to prove that Condition 1 has not been met.

Case:

Client	Leading personal care product distributor
Engagement	Customs valuation – Royalties
Services	<p>Client assessed by Customs as not having paid customs duties and taxes on royalty payments it had remitted to a trademark owner for the distribution of products bearing the said trademark. The total liability amounted to around RMB 8 million.</p> <p>KPMG China conducted a detailed analysis on the nature of the royalties and the characteristics of their arrangement. This was combined with in-depth research of China's Customs laws and regulations, WTO valuation rules, and case rulings on royalties. Ultimately, KPMG China was able to assist the Company in reaching an agreement with Customs that the royalty payments were not part of the dutiable value, thus successfully reversing the Company's liability.</p>

- Service fees

There are no published rules regarding the dutiability of service fees. The service fees are generally paid for various reasons. In determining the dutiability of service fees, China Customs sees whether they are relevant to the production, research and development, and sales of the imported goods by conducting a review of the relevant service agreements and the actual nature of the services. If found to be relevant to the imported goods, Customs includes the service fees in the dutiable value of the imported goods; otherwise, no additional duties and import taxes are imposed.

- Other non-trade payments

During the Customs audit, China Customs requests that the importer provide audit reports, payment breakdowns and other information for their review. If Customs uncovers any non-trade payments, the importer should provide an explanation letter to China Customs to prove that the payments are not connected to the imported goods. If the importer cannot provide any explanation or the explanation letter is found to be unsatisfactory, Customs will determine the non-trade payments as related to the imported goods and impose customs duties and VAT on the said amounts.

Valuation of spare parts under warranty and customs risk management

Another common issue faced by multinational companies pertains to the valuation of replacement parts for products that are covered by warranty. Often these replacement parts are provided free of charge and thus cannot be valued under the transaction value method. In these situations, Customs may value these replacement parts based on average market prices, which would then be used as the basis for import duties and VAT. Customs would also use average market pricing in an effort to avoid price fixing for related party transactions. Nevertheless, if the intercompany prices approximate the average market prices, Customs may accept the actual prices declared in the invoices.



Tariff classification

In China, all the commodities are classified into 22 Sections and 98 Chapters in the HS according to production categories, properties and functions. The first six-digit level HS code is determined based on chapter, heading and sub-heading. China adds a seven to eight-digit level named “country’s sub-heading” based on six-digit level of the HS, and further adds a nine to ten digit level according to Customs supervision and relevant policy.

Since the tariff classification may influence the applicable duty rate for imported goods, export VAT refund rate of export goods, licences/certificates requirements, as well country of origin of goods which have been processed in several countries, a company could face challenges from customs authorities, or even tax authorities, on the classification of its imports/exports.

Case:

Client	Leading manufacturer of high-end consumer goods
Engagement	Tariff engineering
Services	<p>Client assessed by Customs as having improperly declared its imports under an HS Code with a duty rate of 10 percent instead of one with a duty rate of 20 percent. The 10 percent difference amounted to millions of dollars’ worth of back duties and tax.</p> <p>Following an analysis of the product’s characteristics and its manufacturing process, KPMG China made a determination that the original classification was more correct under the classification principles set forth under the HS Convention. Based on KPMG China’s technical analysis and assistance, Customs agreed with KPMG China’s analysis and withdrew the requirement for payment of additional duty and tax.</p>

Processing trade and customs risk management

The implementation of processing trade arrangements has caused various issues not only for companies but also for Customs authorities. The basic logic for bonded treatment under processing trade is relatively simple i.e. all imported raw materials shall be re-exported after being processed into finished goods, or will otherwise be subject to customs duties and import VAT. However, it is practically very difficult to demonstrate or verify in exact terms whether the imported raw materials have all been consumed for the production of the exported finished goods.

It is normal practice for Customs to quantify the overall exposure of a processing trade company through inventory reconciliation. If there is a shortfall in the inventory of bonded materials that should have been used for the production of the exported goods, Customs often assumes that these have been diverted for domestic consumption and thus, subject to customs duties and import VAT. However, if there is a surplus of these bonded materials, the Customs treatment is more ambiguous. In the past, most companies could get Customs' approvals to carry forward surpluses and avoid paying customs duties and import VAT. Nowadays, however, Customs authorities may subject these surpluses to additional probing for possible underlying non-compliance issues. It is no longer uncommon for big multinationals to pay back millions of RMB worth of back duties and VAT on surplus bonded materials. Sometimes Customs may even impose penalties and/or downgrade the company's customs rating. Therefore, companies have to clearly explain to Customs the reasons why these surpluses were incurred.

- Bills of Materials

The main reason for surpluses and shortages that immediately attract the attention of Customs can be traced to the Bill of Material (BOM). The BOM is shared by both the company and the Customs authority to measure how much of the imported raw materials are consumed to produce the exported finished product. However, the information in the BOM held by Customs is different to that contained in the company's internal BOM. The Customs BOM contains leftover information while most internal BOMs do not. Furthermore, most companies make declarations that are not directly based on internal part numbers that are labelled in their BOM. Therefore, it is often necessary to first convert the internal BOM into more items or models with more high-level descriptions for Customs to understand.

For Customs, it is a fundamental requirement to declare an accurate BOM according to actual data. However, this may not be that straightforward from the point of view of companies which find it challenging to identify the "actual BOM" and ensure that this is accurate information. This is because many companies use engineering BOM or standard BOM with quantities that may vary from those that are actually consumed at the production line. Even if a company can provide actual consumption for Customs declaration purposes, it is still necessary to ensure the prompt conversion of units from the internal to the Customs BOM whilst updating the Customs BOM in case of any engineering/design change.

As a big leap forward from the traditional practice of using Customs BOM, GAC Work Order Reconciliation model was formally launched in 2015. This model can help eliminate inventory discrepancies of bonded materials resulted from the difference between actual BOM and filed Customs BOM under traditional inventory reconciliation process, and thus has the benefit of improving compliance practices of processing trade enterprises and reducing their implicit compliance cost. The model, however, sets higher requirements to the Enterprise Resource Planning (ERP) system, production procedures as well as internal control system. Therefore, processing trade enterprises should evaluate the details and implications of this model, and stay informed of the implementation of the model in their customs jurisdictions.

- Internal Controls

Another important area to manage in a processing trade set-up is the internal control of warehouse and inventory management. Without adequate control, companies will find it impossible even to complete proper inventory reconciliation.

Furthermore, the mismanagement of warehouses and raw material inventory will normally result in unjustifiable shortages and surpluses, which could cost companies significant back duties, VAT and penalties.

The importance of sound internal controls has been highlighted by China Customs' issuance of the revised Supervision Measures of Processing Trade Goods, GAC Decree, No.219. Under the revised Supervision Measures, China Customs clarified that bonded goods and non-bonded goods should be stored and recorded separately. If it is impossible to separate the goods, upon the application by the company, China Customs will check the company's internal information management system to make sure that the company manages those goods separately. In practice, it is not yet clearly and uniformly stated how customs will examine companies in different industries or with different MRP/ERP systems. However, it is clear that companies which cannot physically separate their bonded and non-bonded goods should perform a detailed study on how to utilize customs management software in order to virtually separate bonded and non-bonded goods/raw materials. Otherwise, they will face significant customs risks.

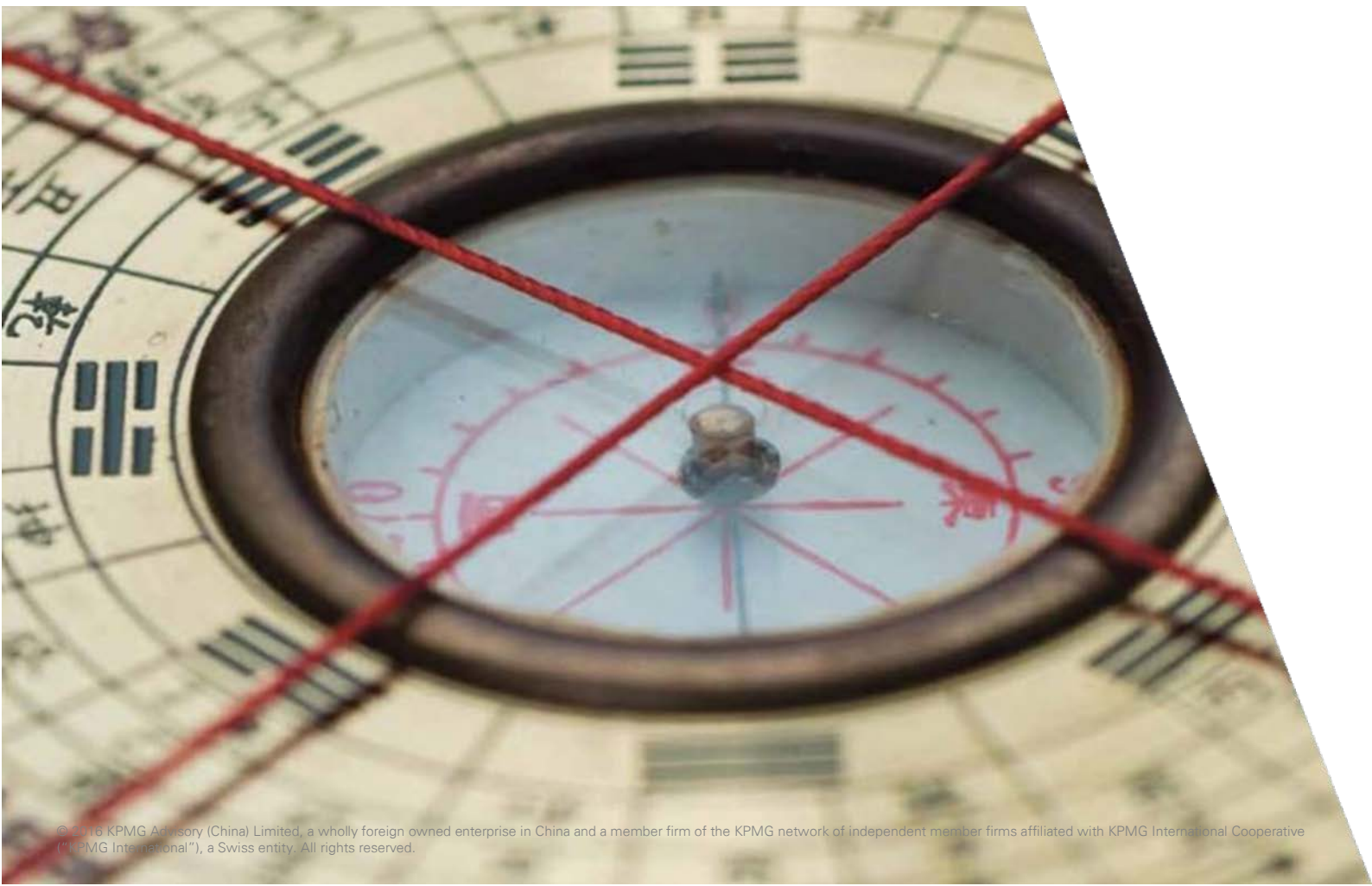
Case:

Client	A fortune 500 electronics manufacturer
Engagement	Internal controls on bonded material
Services	Client sought KPMG's advice to identify the causes and avoid a recurrence of a shortage in bonded materials which cost them over USD 1 million in customs penalties. After KPMG's investigation, analysis and in-depth interviews with personnel from various departments, more than ten reasons for the bonded material shortage were identified. These areas related to six departments within the company. To strengthen internal controls relating to these areas, KPMG assisted the company in developing an integrated customs operations manual and ERP system.

CIQ risk management

With the development of trade liberalisation and Customs clearance facilitation, the barriers from Customs are being reduced or eliminated; however, importers should also pay more attention to the CIQ matters. CIQ issues will affect the time and cost of clearance, customer buying satisfaction and experience, and even administrative penalties, etc. Importers should pay great attention to control risks associated with handling the following goods:

- foods and beverage
- medicine
- electrical appliance and China Compulsory Certificate (3C) products
- complete sets of equipment
- toys
- textiles and clothes
- secondhand goods



D Why and how we can help

- We offer holistic, regional customs solutions

KPMG's Trade & Customs practice is built upon a broad network of customs professionals in all key markets in China and throughout the region. We are able to deliver customs-related advice to our clients on a country, regional and global level. We coordinate closely with other key service lines within the KPMG network, such as TP, Corporate Tax and Advisory. As a result, we are able to offer comprehensive, relevant customs advice.

- We understand your business

KPMG has a strong track record of delivering quality services to multinational corporations, governmental organisations and other entities either directly or indirectly engaged in the cross-border trade of physical goods. In short, any enterprise whose goods must clear customs at any point along a supply chain can benefit from our assistance.

- We live and breathe the regulatory environment

Our experienced professionals come from a variety of backgrounds and include former Customs officers, lawyers, accountants, economists and executive managers from the private industry. In addition to having strong customs backgrounds, many staff members have years of experience in corporate and indirect taxation.

In China, we have specialised Trade & Customs teams in Beijing, Tianjin, Shenyang Qingdao, Shanghai, Guangzhou, Shenzhen and Hong Kong, consisting of up to 50 professionals and technical specialists with backgrounds in economics, finance, accounting and government.



Our professionals include highly experienced former senior Customs officials who are able to effectively represent and articulate our clients' concerns to the Customs authorities. We maintain a close working relationship and conduct frequent technical consultations with the GAC in Beijing and various local Customs authorities.

- Our services

We help our clients reduce customs-related costs and expenses and enhance trade processes and strategies. We help to clarify customs rules and regulations, develop strong working relationships with local Customs authorities and provide guidance regarding the proactive management of customs compliance.

Our team in China is highly experienced and maintains a positive track record in assisting clients before, during and after an enforced customs audit. Our competencies are highlighted by comprehensive industry-specific knowledge and experience that allows us to provide relevant, practical and meaningful advice across various industry clusters. Our other fundamental service offerings include:

- qualification for and benefit from FTAs
- duty reduction through "unbundling" of non-customs costs
- strategic tariff planning
- coordination of transfer pricing and customs valuation
- anti-dumping duty reviews and assistance
- utilisation of FTZs, Logistics
- parks and Customs Bonded Zones
- duty reductions through tiered sales and commissionaire structures
- implementation of customs policies, procedures and internal controls
- compliance reviews
- third-party cost analysis
- preparation of a wholly contained internal compliance program to meet export control requirements

- Call us if you or your company:

1. is interested in reducing its customs and cross-border costs through various strategic trade planning strategies.
2. would like to undertake a proactive assessment of potential customs risks concerning your operations.
3. encounters any of the following issues:
 - TP documentation, methodology or year-end adjustments
 - questions from Customs
 - tax issues on the transfer of bonded goods for further processing
 - potential double taxation due to royalty payments
 - conflicting requirements from tax and Customs authorities
 - challenges by Customs regarding customs value, tariff classification and country of origin

E Our national trade & customs network



Broad coverage

Across 16 cities in China

Dedicated resources

Up to 50 full-time, experienced staff members

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